If Cineplex Inc. (TSX:CGX) Wants to Grow, Its Dividend Has Got to Go

Description

At one point or another, most Canadians have visited a **Cineplex Inc.** (TSX:CGX) location to check out the last Hollywood block buster. But lately, and much like a movie set in the DC Comics universe, Cineplex stock has bombed, trading at a level not witnessed in almost 10 years.

For value investors, now would seem like the opportune time to pick up this household name and serial dividend grower on the cheap. However, based on its recent financials, I would argue that its massive seven percent yielding dividend should be cut, not grown further, in order for this company to present a true value proposition.

Streaming services are the new normal

In order to understand the slump, we must look at broader audience trends. With the increasing popularity of over-the-top streaming services, such as **Netflix, Amazon Prime** and now an offering from **Disney** all competing for viewership, movie goers have never been more spoiled in the quantity and accessibility of content. This shift in consumer sentiment is never more evident than in Cineplex's year-over-year theatre attendance, which drifted lower to 69.3 million attendees in 2018, from 70.4 million in 2017, and 77 million in 2015.

And that's not all. Falling attendance means also means falling advertising revenues, as evidenced by declines in pre-show revenues of 6.3 percent in 2018 compared to 2017.

Moreover, with a slew of options available to audiences on the streaming front, viewers can afford to be choosy with what they shell out their hard-earned money for, and opt out of viewing anything but the loudest, highest budget, explosion-laden Hollywood spectacles. Indeed, in 2018 for example, over 55 percent of the US domestic box office was carried by the top 20 grossing movies (which of course featured the usual suspects from the major superhero franchises).

Given where we are, it's become clear that audiences are favouring quality over quantity, and in in order to entice patrons into seats, the movie experience has to become well… an *experience* as opposed to an *outing*.

Cineplex knows this.

From its 2018 financials, the company added 10 additional screens across its 164 theaters, which included additions from its premium offerings (such as 10 additional 3D Digital Screens and three UltraAVX screens). Furthermore, Cineplex continues to renovate its existing locations, with plans on adding ancillary entertainment options such as *Playdium* and VR-based video games to its auditoriums. At the same time, Cineplex also has lofty ambitions to increase its rollout of *Rec Room* locations across the country (Rec Room is Cineplex's one-stop location for arcade games, VR and restaurants), as part of a brand overhaul.

All of these upgrades and renovations of course mean tremendous cash burn. In 2018 the company spent $19.5 million in maintenance capital expenditures alone, while dishing out north of $94 million in property, plant & equipment.

With such a high degree of cash burn necessary to grow the company, where then does one find a place for the dividend?

While you can argue that on a net income basis the payout ratio is a manageable 61 percent, once you take into account free cash flows (operating cash flows minus capex) as the denominator, you begin to see a more accurate picture of the strain the dividend is placing on the company: the payout ratio jumps north of 100 percent.

Given the company's lofty ambitions to rebrand itself as a diversified entertainment provider and compete against the streaming services on a value proposition as opposed to price, it's quite evident that Cineplex needs to reduce its dividend in order to scale up its expansion plans.

Further, the numbers have shown that theatre patrons respond positively to the value angle, as revenue per patron ticked upwards in 2018 based on price hikes on tickets and concession offerings. But price hikes alone will only get you so far: in order to justify the rising prices, Cineplex will have to offer an overall more premium theatre-going experience across the board through renovated auditoriums, increases in D-Box and AVX screens (note, these higher end channels alone were responsible for 44 percent of overall theater revenues in 2018) and better menu offerings.

All these will come at a cost however, and in order to flip the script from a bargain name to a growth stock, Cineplex will have to slash that dividend.

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